



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced	<b>02/21/03</b>	Bill No:	<b>SB 676</b>
Tax:	<b>Tobacco Products Fee</b>	Author:	<b>Ortiz</b>
Board Position:		Related Bills:	

***This analysis will only address the bill's provisions that impact the Board.***

### **BILL SUMMARY**

This bill would impose a tobacco products fee, as specified, on each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have significantly contributed or currently contribute, or both, to tobacco-related illnesses and diseases.

### **ANALYSIS**

#### **Current Law**

Under current law, Section 30101 of the Cigarette and Tobacco Products Tax Law imposes an excise tax of 6 mills (or 12 cents per package of 20) on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. Currently, the surcharge rate for fiscal year 2002-03 is 48.89 percent.

#### **Proposed Law**

This bill would add Part 5.5 (commencing with Section 105500) to Division 103 of the Health and Safety Code as the Taxpayers' Tobacco Relief Act of 2003. Among its provisions, Section 105520 would impose, on or after January 1, 2005, a tobacco products fee upon each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have significantly contributed or currently contribute, or both, to tobacco-related illnesses and diseases. On or before January 1, 2005, the Department of Health Services (DHS) would be required to establish, by regulation, specific fees to be assessed based on both of the following factors:

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- The annual cost to the state and local governments to treat individuals with tobacco-related illnesses and diseases, minus any revenues received by the state and local governments as a result of tobacco taxes, federal legislation, or lawsuits against manufacturers of tobacco products if the revenues are specifically earmarked to reimburse the state and local governments for the cost of treating individuals with tobacco-related illnesses and diseases.
- The manufacturer's share of the California tobacco products market as determined by the department.

The tobacco products fee would be annually adjusted by the DHS to reflect the following:

- Any change in the annual cost to the state and local governments to treat individuals with tobacco-related illnesses and diseases.
- Any change in the revenue received by the state and local governments from the tobacco tax, federal legislation, or lawsuits against manufacturers of tobacco products, if the revenues are specifically earmarked to reimburse the state and local governments for the cost of treating individuals with tobacco-related illnesses and diseases.
- Any changes in the manufacturer's share of the California tobacco products market, as determined by the department.

The Board would administer the fee imposed in accordance with the Fee Collection Procedures Law, which contains "generic" administrative provisions for the administration and collection of fee programs to be administered by the Board. The Board would assess the fee imposed commencing April 1, 2005, and annually thereafter. The fees would be deposited in the Tobacco-Related Health Care Costs Trust Fund, which this bill would create. The fund would consist of the State Account and the Local Government Account, with monies expended to reimburse the state and local governments for the costs of treating individuals with tobacco-related illnesses and diseases.

Section 105510 would define "tobacco product" to mean cigarettes and all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing, at least 50 percent tobacco.

This bill would become effective January 1, 2004.

### **Background**

According to a report<sup>\*</sup> by the University of California, San Francisco (UCSF) School of Nursing Institute for Health & Aging, smoking costs in California are nearly \$16 billion annually, or \$3,331 per smoker every year. The report states that direct health care costs of smoking account for 54 percent of the total cost of smoking in California - \$8.6 billion. Expenditures for hospital care of current and former smokers amount to \$4.0

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<sup>\*</sup> The Cost of Smoking in California, 1999.

<http://www.dhs.ca.gov/tobacco/documents/CostOfSmoking1999.pdf>

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billion, or 47 percent of total direct medical costs; ambulatory care services amount to \$2.1 billion or 24 percent; nursing home care amounts to \$1.3 billion or 15 percent; prescription drugs amount to \$1.1 billion; and home health care amounts to \$87 million.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to hold manufacturers of tobacco products financially liable for the adverse health effects of their products.
2. **Suggested technical amendments.** The following technical amendments are suggested to clarify the intent of the measure:

- The term "tobacco products" should be clarified to further define the term "cigarettes." If the author intends for tobacco products to mean cigarettes and tobacco products as defined in the Cigarette and Tobacco Products Tax Law, the following language is suggested:

105510. (d) "Tobacco product" means ~~cigarettes and all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing, at least 50 percent tobacco~~ cigarettes as defined in Section 30003 of the Revenue and Taxation Code and tobacco products as defined in subdivision (b) of Section 30121 and subdivision (b) of Section 30131.1 of the Revenue and Taxation Code.

- A date by which the DHS is required to set the tobacco products fee rate each year and notify the Board should be specified. Further, it is recommended that such date be at least 8 weeks prior to the effective date of the rate to provide Board staff sufficient time to notify industry before a fee rate change and to provide industry sufficient time for reprogramming.
- The operative date of the fee should be clarified. Section 105520(a) indicates that the fee would be paid on and after January 1, 2005. However, subdivision (e)(2) provides that the Board would assess the fee imposed commencing April 1, 2005.
- A due date for the fee and return should be specified. It is also recommended that the bill be amended to authorize the payment of refunds on overpayments of the fee and authorize reimbursement for the Board's costs of administration.

Board staff is willing to work with the author's office in drafting appropriate amendments.

3. **Could the state require out-of-state manufacturers to remit the tobacco products fee?** Various Supreme Court cases have focused on states' ability to impose the use tax on out-of-state firms making sales to in-state customers. In 1967 the Supreme Court ruled in *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967), that a firm that has no link to a state except mailing catalogs to state residents and filling their orders by mail cannot be subject to that state's sales or use tax. The Court ruled that these mail order firms lacked sufficient

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nexus required by the Due Process Clause and the Commerce Clause of the United States Constitution.

In the 1977 case of *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 {51 L.Ed.2d 326, 97 S.Ct. 1076} the Court articulated that, in order to survive a Commerce Clause challenge, a tax must satisfy a four part test: 1) it must be applied to an activity with a substantial nexus with the taxing State, 2) it must be fairly apportioned, 3) it does not discriminate against interstate commerce, and 4) it must be fairly related to the services provided by the State.

North Dakota enacted anti-*National Bellas Hess* legislation with the expressed purpose of creating nexus with mail order firms selling to consumers in the state, in an attempt to compel out-of-state retailers to collect the use tax on mail order sales and test the continuing validity of the *National Bellas Hess* decision. The statute was challenged, and in 1992 the Supreme Court issued a ruling in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298. The Court in *Quill* applied the *Complete Auto Transit* analysis and held that satisfying due process concerns does not require a physical presence, but rather requires only a minimum contacts with the taxing state. Thus when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the state's requiring the retailer to collect the state's use tax. However, the Court held further that physical presence in the state was required for a business to have a "substantial nexus" with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed that in order to survive a Commerce Clause challenge, a retailer must have a physical presence in the taxing state before that state can require the retailer to collect its use tax.

Based on the above cases, it is questionable whether the state could require an out-of-state manufacturer of tobacco products, who has no physical presence in California, to remit the fee.

4. **This bill could increase state and local sales and use tax revenues.** In order to be reimbursed for the fee, tobacco product manufacturers may increase the price of tobacco products, which would be reflected in the retail sales price of tobacco products sold to the ultimate consumer.

Sales and use tax is due based on the gross receipts or sales price of tangible personal property in this state. Since the proposed tobacco products fee would not be specifically excluded from gross receipts or sales price, it would be included in the amount on which sales or use tax is computed.

5. **Would the proposed tobacco products fee increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. In 1999, Board staff spent considerable time developing a variety of statistical approaches to estimate cigarette tax evasion. In addition, Board staff reviewed numerous studies of behavioral responses of smokers to price changes as well as studies that estimated tax evasion. Using a baseline statistical model, Board staff estimated that cigarette tax evasion in California was running at annual rates of approximately \$130 to \$270 million. The estimate was only for evasion of excise taxes, and did not include associated evasion of other taxes, such as sales and use

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or income taxes. A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates.

Two major events since November 1998 have dramatically increased California cigarette prices: the Proposition 10 tax increase and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an unspecified fee on each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, as specified. This fee could result in an increase in the selling price of tobacco products, which based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement, would cause a correlated increase in tax evasion.

## **COST ESTIMATE**

The Board would incur non-absorbable costs to adequately develop and administer a new fee program. These costs would include registering fee payers, developing computer programs, mailing and processing returns and payments, carrying out compliance and audit efforts to ensure proper reporting, developing regulations, training staff, answering inquiries from the public, and investigative efforts. A cost estimate of this workload is pending.

## **REVENUE ESTIMATE**

This measure does not specify the amount of the tobacco products fee. Accordingly, a revenue estimate could not be prepared.

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